James Brearley

Investment Managers & Stockbrokers
Established 1919

Investment Risk Guide

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Introduction

This document is designed to help those clients utilising our Execution-Only service to better understand the risks associated with different investment instruments. Risk is subjective and an individual's perception will vary considerably, however we hope that by detailing the general risks associated with each type of investment vehicle, made available via our Execution-Only service, that this will help in your determination as to whether or not the investment is suitable for you.

What do we mean by risk?

This document has been produced to assist our clients in understanding the risks associated with different types of investment.

We believe that most investors define risk in terms of the level of capital they are prepared to lose over a given period of time.

Our team of Account Executives are able to answer any questions you may have and to provide you with further guidance.

Understanding Risk

All financial instruments carry a certain degree of uncertainty as to their future performance. The extent of this uncertainty varies depending on the financial instrument. When we refer to risk, we are highlighting the possibility that the value of your assets may fall. We may also mean that any income you receive may fall. It may be possible that you could receive no income or the value of an asset may fall to nothing.

The risks of different types of investments made available via our Execution-Only Service

There are many different types of investment and they each have different characteristics and carry different degrees of risk. We describe these and the risks associated with them below.

Cash Deposit

What is it? Cash held on deposit with a financial institution (e.g. a bank or building society account).

The risks: Cash deposits are generally considered a safe place to invest. However, if the deposit taker (e.g. the bank or building society) experiences financial difficulties it may be unable to repay the amount you deposited. Certain clients may be protected by the Financial Services Compensation Scheme but limited to the maximum amount of that scheme.

You should also remember that if the rate of inflation is higher than the rate of interest you receive on your cash deposit, the real value of your money (i.e. what you can buy with it) will reduce over time.

The returns: You may receive interest on the amount held. This may vary depending on how long you are prepared to leave your cash on deposit without making a withdrawal. Generally, the longer the term you are prepared to leave your cash on deposit for, the higher the rate of interest you will receive.

Fixed Interest Investments

What are they? A fixed interest investment (or bond) is one which pays interest at a fixed rate throughout the term of the investment. This may be a loan by you to a government, company or overseas country. Examples include: British government securities (referred to as Gilts), corporate bonds (issued by companies) and sovereign bonds (issued by overseas countries).

The risks: Generally speaking, corporate bonds are perceived as being less risky than holding shares in a company. The main risk is that the company to which you have lent the money cannot pay the interest due or repay the capital sum at the maturity date. This is referred to as the default risk and in the event of the liquidation or winding up of the company could lead to you losing your entire investment.

It is generally the case that bonds issued by governments are seen as safer than those issued by companies (although this depends on the particular country). As a consequence, governments usually pay a lower rate of interest to reflect the lower level of risk than with a corporate bond.

Other risks include:

- A change in the credit rating of the bond issuer – a perceived increase in the risk of default usually means a lower value is placed on the bonds.
- Changes in interest rates – a rise in interest rates means the rate of income offered by the bond will be less attractive and a lower value is placed on the bonds.
- Changes in inflation – a rise in inflation will reduce the real value of a conventional bond.
- Life of the bond- typically the longer a bond has to run before its maturity date, the greater the impact one of these changes will have on its value.

The returns: A "conventional" bond pays a fixed rate of income until the loan is repaid on the maturity date. There are also index-linked bonds where the rate of income and the amount repaid is linked to a specific price index (usually the Retail Price Index) so that the investor maintains the purchasing power of their capital throughout the life of the bond.

Most bonds are listed on an exchange which means that you can sell a bond before its maturity date. You will receive the market price for the bond together with any accrued interest. Although a conventional bond is not designed to provide capital growth, you may make a capital gain by selling at a higher price than you paid.

Most sterling denominated bonds are deemed as “qualifying bonds” which means they are exempt from capital gains tax.

Zero Dividend Preference Shares

What are they? A type of share issued by a split capital investment trust (one which usually issues two classes of shares where one share class is entitled to income and the other capital growth).

The risks: Zero Dividend Preference shares are normally seen as being less risky than other classes of share issued by the investment trust. Whilst there is a predetermined redemption date, repayment is subject to there being sufficient assets within the trust at redemption to repay the capital. However, they usually rank higher in any liquidation or winding-up of the trust (meaning they are repaid ahead of other classes of share).

The returns: As the name suggests, a Zero Dividend Preference Share pays no dividend. When the investment trust is wound up, the shares are repaid at a pre-determined (but not guaranteed) redemption price. A profit on sale or redemption is treated as a capital gain.

Structured Products

What are they? Structured products are a type of fixed-term investment where the amount you receive back at the end of the term and possibly the income that it pays out over this period, is determined by the performance of the index or indices, to which it is linked. Some structured products offer a degree of capital protection, whilst others do not. The income or growth is usually not guaranteed and you may get no return on your investment.

The risks: Certain structured products offer that a minimum level of your capital will be returned irrespective of the performance of the index (or indices) to which they are linked. In contrast, other structured products will experience a capital decline which is linked to the fall in the index (or indices). It is therefore important to understand exactly what the characteristics and conditions of return are before investing in a structured product.

In addition, the issuer of each structured product, typically a leading bank or financial institution, needs to have sufficient financial reserves to meet their financial obligations as these fall due.
In certain instances, additional capital security can be achieved if the product is backed by government issued securities.

As these securities are meant to be held for their full term it may be difficult to liquidate or sell them. As this is only possible by approaching the dealing desk of the issuing bank, it may equally be difficult to determine an independent fair value for a structured product. Because of these factors and being based on one or more derivatives, structured products are deemed to be complex instruments and may not be suitable for you.

James Brearley views structured products as being less risky than investing in the index or indices to which they are linked, itself. Typically, the structured product offers a minimum capital return or the relevant index must fall considerably before your capital is at risk.

The returns: The majority of structured products offer returns based on the performance of one or more stock market indices. This may be in the form of a set level of return based on a certain index level being achieved on or by a certain point in time, which could accrue as a capital entitlement or in the case of income based structured products, be distributed. Alternatively, the return may be in the form of a percentage of the increase in the index (or often a "basket" of indices) from the structured product's point of issue to its maturity. This is commonly referred to as the "participation" rate. A participation rate of 130% means that for each 1% increase in the index the structured product provides a return of 1.3%. Any profit on sale or redemption is treated as a capital gain.

Commercial Property Funds

What are they? A Commercial Property Fund is a fund which invests in commercial property such as office buildings, industrial property, hotels, retail premises, warehouses, etc. It does not invest in residential property such as houses.

The risks: By investing in a fund, your investment is not invested in one property but goes towards investing in a number and range of properties. This has the effect of diversifying your risk. There are, however, a number of things to bear in mind:

- Whilst the value of commercial property may increase over time, it may also fall.
- Commercial property can be difficult to value at a specific point in time. The 'fair' value of your share of the fund may be difficult to determine.
- Income and other returns can depend on the commercial properties being let, rents being received, etc.
- Commercial property can be difficult to sell quickly, for example, if there is a requirement to repay a large number of investors. The manager of a Commercial Property Fund may therefore retain a proportion of the fund in cash or listed property securities. To protect the interests of all investors, in extreme circumstances, the fund manager may impose penalties on those wishing to liquidate part or all of their holding or choose to restrict disposals altogether.

Despite the above, the value of an investment in a Commercial Property Fund will generally change less over time than investments into a share or other market investment. James Brearley therefore views Commercial Property Funds as being less risky than investments into a share or other stock market investment.

The returns: Investing in a Commercial Property Fund may provide you with capital growth and income.

Infrastructure Funds

What are they? A listed infrastructure fund operates in a very similar way to a closed ended vehicle/investment trust, investing in a wide range of infrastructure projects. As these commonly involve some form of government involvement the projects typically fall under one of two possible labels: a Private Financial Initiative (PFI) or a Public Private Partnership (PPP). Typical examples include the building and maintenance of Schools, Hospitals, Toll Roads or Bridges.

What are the risks? Given the underlying entity for most infrastructure projects is typically a government department, the risk of potential non-payment is relatively low. As the annual maintenance charge is usually subject to an inflation linked review this also helps reduce the inflation risk and to a lesser degree the interest rate risk. However, the projected income return may be adversely affected by unforeseen or understated operational costs. In the case of buildings this could result from the need to replace such things as elevators, roofs and air conditioning. The building is also likely to need at least one major refurbishment during its life which could cost more than the projected cost due to inflation being higher than that used in the forecasts. Given the reliance on government funding policies in general, a change of government may have an adverse effect on infrastructure valuations.

The Returns: Listed infrastructure funds typically pay a half yearly dividend to their shareholders forming the lion share of the return they offer. Whilst some capital appreciation is possible this is likely to be fairly limited.

Equities (Shares)

What are they? In simple terms, a share is part of a company. Where a company's capital is divided into small equal parts, a share is one of the parts. Amongst other things, a share gives entitlement to share in the company's profits.

The risks: Shares are volatile and their price will fall or rise over a period of time. You may get back nothing at all. Similarly, the dividend or income received can vary over time and is not guaranteed. The price of shares can be affected by many factors including supply and demand, market sentiment and threats to profitability.

Investing in shares is generally seen as being more risky than investing in other assets such as bonds. The risks of investing in shares also depend on the nature of the company, how it generates its profits, how it is run, etc.

Shares in larger companies in the more substantial economies of the world are usually seen as being less risky than smaller companies, wherever in the world.

A further risk concerns the market on which the equity is listed, with the highest standards of governance applicable to shares with a full listing on the London Stock Exchange. The AIM market for example, has less stringent listing requirements then those companies with a full market listing.

If investing in overseas companies then these are likely to be subject to the additional risk of an adverse movement in foreign exchange rates between sterling and the company's core currency.

The returns: When investing in shares, the return may be in the form of capital growth (i.e. the value of your share grows as the value of the company grows or becomes more profitable). You would usually expect to receive a return in the form of income as the company distributes its income (or profits) to its shareholders (i.e. a dividend).

Funds

What are they? A fund provides investors with the ability to pool their investment capital with that of other investors, which in turn is then managed on their behalf by the fund group's investment management team. Funds are typically focused on a particular market or region of the world and usually exposed to one particular type of investment instrument. However, the investment mandate of some funds may cover a variety of different investment vehicles and also incorporate a global mandate. Most funds are "open ended" which means that there are no restrictions on the number of units in the fund that can be traded which is normally at the fund's net asset value. In contrast "closed ended" funds, such as investment trusts, have a restricted number of shares and so they may change hands at a different price to their stated net asset value, driven by supply and demand.

The risks: The risks affecting funds typically follow which investment types are held by it. So a fund concentrating on fixed interest investments will be subject to the same risks as those detailed for fixed interest investments in this document, and likewise for equity funds.

Because of the pooling arrangement, an investor's exposure to any one holding will be much less than having a direct investment in that asset type. The number of holdings within a fund will vary though and so a more concentrated UK equity fund is going to be of higher risk than a UK equity fund with significantly more positions.

In every instance, we will only make funds available to clients using our Execution-only service, that have been designed and classified by their fund management group, to be suitable for retail investors.

Warrants

What are they? A warrant is an investment which gives you the right to buy or sell shares, bonds or government securities at a stated price and within a pre-determined timescale. A warrant is exercised against the issuer of the investment.

The risks: A warrant is a geared investment so a relatively small price movement of the underlying investment may result in a disproportionately large movement in the price of the warrant. The prices of warrants can change very quickly over time.

If an investor fails to exercise their right to purchase within the pre-determined timescale, the warrant becomes worthless and you will lose all of your investment in the warrant.

Warrants are higher risk than the investment over which they have rights.

The returns: There is potential for large capital gains.

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